THE FIRST NATIONAL CITY BANK OF NEW YORK

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First National City Bank Monthly Letter

Business and Economic Conditions

New York, May 1960

General Business Conditions

THE arrival of spring brought the expected upturn in trade, as well as in all outdoor activities, and, despite some disappointments with first quarter profits figures, has had a reassuring effect on sentiment. While industrial production has slipped off further from its January peak, some improvement in the flow of new orders has been noted, and total employment, inclusive of construction and agriculture, is rising. Businessmen have raised their sights on capital spending.

The greater part of the drop in industrial production since January is attributable to the steel and automobile industries. Steel users after the strike did not push inventory accumulation as far as many observers had expected. Some had thought that the industry could operate at 90 per cent or better well into the spring months, but that did not prove to be the case. At the same time dealers' stocks of automobiles were built up to an unusual degree in the early weeks of the year and output cuts were under way by February. Whether operations in these two major industries have dropped as low as necessary to bring supply and demand back into balance is still a matter of opinion, with the preponderant evidence in steel, at least, suggesting that still lower rates are likely. The important point, however, is that, with final consumption well sustained, these corrections do not appear to be setting off a cumulative decline.

In the first quarter, inventory rebuilding reached an annual rate of $9 billion compared with $3 billion in the fourth quarter. Despite this rate of accumulation, the inventory levels reached, with some exceptions such as autos, are conservative when related to sales volume. The turn to a diminished rate of accumulation, or to a level trend, simply means that business is not in an inventory-building boom. A corollary is that it is less vulnerable to sudden contraction. At the beginning of the year many forecasters expected inventory buildup to hold the economy at boom levels through approximately the first half year. The implication of this prophecy was that the situation in the second half year would be weaker. In fact, however, the inventory buildup reached its climax earlier and at lower levels than many expected, and the corrective decline in output has also come earlier. This is a reason for thinking that some of the expected second half weaknesses are less likely to appear. Plainly, the second half year will have the support of further expansion in expenditures on plant and equipment.

The over-all output of goods and services during the first quarter reached a seasonally adjusted annual rate of $498 billion. There was some disappointment that the gross national product narrowly failed to achieve the half trillion dollar mark as had been widely anticipated, but aggregate output exceeded that in any previous quarter in the nation's history by a considerable margin.

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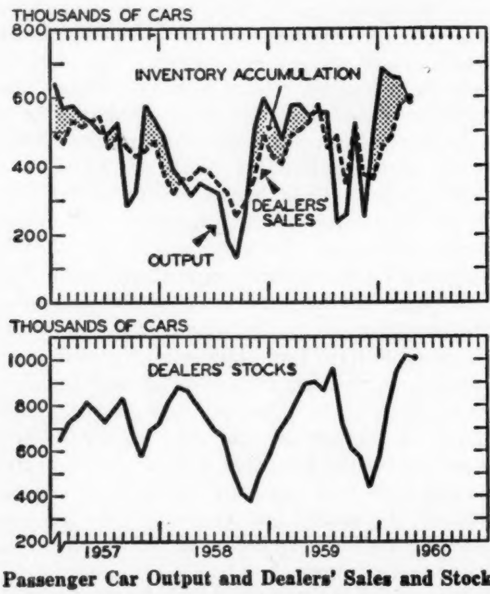
Brisk Spring Sales

The factor of inventory increase should not obscure the strong advance of $8.5 billion in final demand for goods and services during the first quarter of 1960. Consumers, business, and state and local government shared in this advance.

The marked rise in retail sales in late March and early April lends plausibility to the feeling that bad weather was primarily responsible for disappointing business earlier. Easter sales, in fact, set a new record. During the six weeks before Easter, department stores sold 11 per cent more than in the corresponding weeks last year. Auto sales, which earlier had disappointed many observers, picked up briskly in late March and April. In mid-April, new cars were selling at the rate of 23,000 a day, up 15 per cent from the corresponding March period and also from a year earlier. The rise in sales has encouraged expectations of a continuing spring upsurge in car buying — a familiar pattern before 1956 but less common in more recent years. Through April 20 of this year, sales of new domestic passenger cars have run one seventh ahead of 1959.



Passenger Car Output and Dealers' Sales and Stocks

New Domestic Passenger Cars Only; Monthly, Jan. '57 - Apr. '60
Shaded areas represent inventory accumulation (plus a small volume of factory sales for export).

Source: *Ward's Automotive Reports* (Sales and stocks for April 1960 estimated by this bank at about 600,000 and 1,000,000, respectively.)

While automobile sales rose in April, production was still being adjusted downward, as shown in the accompanying chart. The addition of nearly half a million cars to dealers' stocks during the first quarter of the year had raised the total from the relatively low level of 575,000 on December 31 to a record-breaking 1,020,000 on March 31 (not to mention 156,000 imported cars also in dealers' hands). But between a 10 per cent curtailment of production from the March rate and a marked rise in sales, accumulation of dealer stocks was arrested during April. In relation to the expanded sales volume, stocks are approximately in line with the 40 to 45 days' supply considered desirable for today's wide range of styles, colors, and optional equipment. Sizable stocks, indeed, encourage buying interest as well as dealer sales effort.

Reduced production of autos was largely responsible for the continued moderate decline in the Federal Reserve index of industrial production (seasonally adjusted, 1957 = 100) to 109 in March from 109.5 in February and the record of 111 in January. Output of capital goods and defense equipment was unchanged in March and close to earlier peak rates, while materials output held steady despite reduced steel mill operations.

In attempting to achieve a balance between production and consumption, steel mills cut their operating rate from 93 per cent of capacity in mid-March to 78 per cent in mid-April. According to *Steel* magazine, finished steel inventories had been reduced to around 8 million tons at the end of the strike, but were rebuilt to approximately 19 million tons by the close of the first quarter. About 1 million tons more, or roughly 5 per cent of current shipments, is expected to go into stocks during the second quarter, leaving steel inventories at mid-year at the comfortable level of about 90 days' consumption.

New Record in Plant and Equipment Outlays

From current and prospective business capital investment, it is evident that management has maintained confidence amid the flurry of disappointing developments earlier this year. Since the beginning of 1960, production of capital goods has been at record levels, while outlays on industrial, commercial, and utility construction have been near the 1957 peak. New orders for such key items as machine tools, nonelectrical machinery, and structural steel increased in March over February.

The most persuasive new evidence is the survey of plant and equipment expenditure plans, just published by McGraw-Hill, and conducted in late March and early April, when businessmen had had ample opportunity to review their plans in light of early 1960 experience. This survey reports that business investment is scheduled to increase 16 per cent in 1960 over 1959, compared

with a 14 per cent rise indicated by a similar survey made in January and February by the Department of Commerce and the Securities and Exchange Commission. Last October, when McGraw-Hill made a preliminary check of 1960 investment plans, an increase of only 10 per cent was anticipated.

Altogether, business expects to spend a record $37.9 billion on new plant and equipment during 1960, topping the previous peak of $37 billion in 1957. Manufacturing firms anticipate outlays of $15.2 billion, an increase of 26 per cent from 1959, but not quite up to the 1957 mark of $16 billion. Significantly, 80 per cent of 1960 expenditures in manufacturing will be for machinery and equipment, and only 20 per cent for buildings. The emphasis is on modernization, not on expansion. The main reason for this is the already ample capacity in many lines. Manufacturers reported that at the end of 1959 they were operating at 85 per cent of capacity, compared with their preferred operating rate of about 94 per cent. On the whole, capital outlays in 1960 are expected to add about 5 per cent to existing capacity — the smallest increase in 10 years, except for 1958. Outlays on research and development, at a record $9 billion in 1959, are expected to rise to $9.6 billion in 1960.

First Quarter Corporate Earnings

Indications from first quarter corporate reports are that earnings increased from the level of the fourth quarter of 1959 and were modestly higher than in the initial quarter of 1959 when business was rebounding from the 1958 recession. Reports issued to date by 812 companies, mostly in manufacturing, show combined net income after taxes of $3.4 billion for the first quarter, an increase of 8 per cent from the fourth quarter of 1959 and a 5 per cent increase over the first quarter of 1959.

Reports for the manufacturing group alone, numbering 622 companies, indicate that profits were 12 per cent above the fourth quarter 1959 level and picked up 5 per cent over the initial quarter of last year. There is normally some decline between the fourth and first quarters. Thus, the reports so far available give encouragement to the hope that corporate profits, in common with most other dollar aggregates of economic data, might achieve a new high in 1960. Nevertheless, there is some disappointment that profits do not seem to be showing the vigorous response to the recent high level of business that had been expected. First quarter results are falling well short of those of the high second quarter of 1959, prior to the steel strike. By and large, it is apparent that competition, at home and abroad, is testing the capacity of managements to control costs and protect the profit margins which, in the final analysis, are essential to survival.

For 489 manufacturing companies reporting sales figures, the aggregate first quarter sales billed increased by 8 per cent over the initial quarter of 1959, with four out of five companies reporting gains. The average net profit margin after taxes on sales narrowed from 6.8 to 6.6 per cent.

NET INCOME OF LEADING CORPORATIONS FOR THE FIRST QUARTER

(Dollar Figures in Thousands)

No. of Cos.	Industry Groups	Reported Net Income After Taxes: First Qr. 1959	Fourth Qr. 1959	First Qr. 1960	Per cent Change From: First Qr. 1959	Fourth Qr. 1959
38	Food products and beverages	$ 71,494	$ 86,852	$ 72,405	+ 1	—17
9	Tobacco products	51,712	60.225	55,286	+ 7	— 8
31	Textiles and apparel	26,656	39,757	29,527	+11	—26
10	Tires, rubber products	27,890	25,768	26,653	— 4	+ 3
30	Paper and allied products	49,361	60,202	50,866	+ 3	—16
39	Chemical products	221,756	228,153	233,374	+ 5	+ 2
27	Drugs, soap, cosmetics	82,999	92,728	91,586	+10	— 1
34	Petroleum producing and refining	595,394	603,582	614,182	+ 3	+ 2
42	Cement, glass, and stone	80,917	104,334	82,244	+ 2	—21
35	Iron and steel	313,594	156,357	338,854	+ 8	+—†
32	Electrical equip., radio and television	90,860	160,209	97,572	+ 7	—39
50	Machinery	68,998	104,077	87,331	+27	—16
121	Other metal products	177,106	166,305	172,678	— 3	+ 4
40	Automobiles and parts	509,422	300,980	540,090	+ 6	+79
25	Other transportation equipment	42,145	41,799	38,205	— 9	— 9
59	Miscellaneous manufacturing	87,895	125,278	97,589	+11	—22
622	Total manufacturing	2,498,199	2,356,601	2,628,442	+ 5	+12
19	Mining and quarrying	29,945	33,089	30,064	+—†	— 9
39	Trade (retail and wholesale)	37,490	58,885	36,623	— 2	—38
21	Service and amusement industries	21,160	24,904	20,985	— 1	—16
49	Railroads	99,991	174,746	99,508	—†	—43
59	Electric power, gas, etc.	262,895	199,314	278,008	+ 6	+39
3	Telephone and telegraph	274,587	310,881	303,263	+10	— 2
812	Total	$3,224,217	$3,158,420	$3,396,893	+ 5	+ 8

† Increases or decreases of under 1% or over 100% not shown.

There was considerable diversity of experience among individual companies, and, as the table shows, among major industry groups. Profits of the steel companies were temporarily swollen by a record production rate, and improved plant efficiency, as the mills rebuilt their customers' inventories after the long strike. The automobile companies bettered their results in the first quarter of 1960, but not by so much as might have been expected from the one-fourth gain in unit volume of factory sales. The most obvious explanation is diversion of production from more expensive standard-size vehicles to compact cars, limiting gains in both dollar volume and net earnings.

The petroleum industry, aided by reduced drilling expenses, reported some recovery in profits which for two years have been held down by price weakness. On the other hand, weather conditions retarded sales and earnings of producers of building supplies and, in conjunction with the later date of Easter, hurt the results of retail merchants. Chemical companies as a group, with some help from enlarged export demand, improved upon their first quarter 1959 performance as did most companies in the electrical, paper, and machinery fields. Textile firms, sorely depressed in 1958, enjoyed a relatively favorable first quarter while narrowed profit margins adversely affected tire companies. Industries showing continued year-to-year growth include tobacco; drugs, soap, and cosmetics; and telephone, electric power and gas utilities. The railroads held about even with first quarter 1959 results. Reports of aircraft engine and air frame manufacturing firms showed adverse effects from cutbacks in government orders and heavy development expenses.

Cash dividend payments in the first quarter by all U.S. corporations issuing public reports advanced 7 per cent from the same period a year ago, according to Department of Commerce figures. Disbursements were up in nearly every major industry group, reflecting both a prevalence of dividend rate increases over decreases and, in some cases, enlargement of share capital.

The number of dividend changes, as reported by individual companies and compiled by the *New York World Telegram & Sun*, also reveals the sharp rebound last year over 1958 and continued improvement this year in the favorable changes (initial, resumed, increased, and extra) and a drop in the unfavorable changes (reduced and omitted). This reversal of trends may be seen from the following summary:

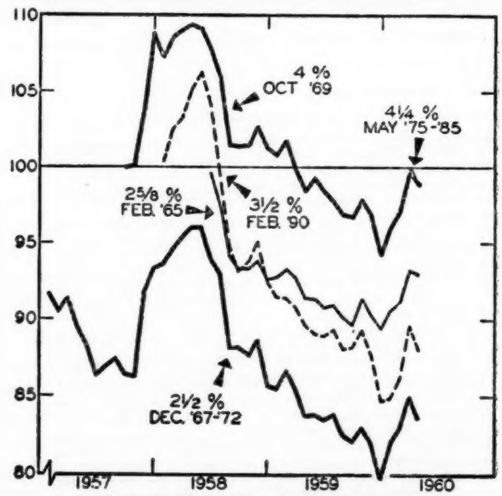
Numbers of Publicly Reported Cash Dividend Changes in the First Quarter

	1957	1958	1959	1960
Initial dividends	111	57	98	182
Resumed dividends	9	2	37	27
Increased dividends	196	126	239	279
Extra dividends	191	147	158	157
Reduced dividends	24	122	42	26
Omitted dividends	36	72	21	26

Treasury Financing

After the close of business on April 28, the Treasury announced that it will invite holders of $6.4 billion certificates and notes coming due on May 15 to accept in exchange 4⅜ per cent one-year certificates of indebtedness or 4⅝ per cent five-year notes. It is hoped and expected that most holders of the maturing obligations will accept one or the other of these exchange offerings, to hold down the drain on the Treasury from cash redemptions. Consideration had been given to paying off the May 15 certificates and notes in cash and raising the money by cash offerings but the advice of market professionals – to which the Treasury acceded – was that, in view of the incomplete digestion of the 4 per cent notes sold April 14, the job of raising $6.4 billion on another cash offering would have required higher interest costs.

Bond prices tended to weaken during April and there was thus no opportunity for the Treasury, within the legal 4¼ per cent rate limit, either to offer bonds in connection with its May financing or to launch the much discussed "advance refunding program." The Treasury's offering a month ago of 15-25 year 4¼ per cent bonds produced sales of only $370 million, against a hoped for subscription of at least $500 million and a



Prices of Selected Treasury Bonds
Closing Monthly Bids: Latest Plotting, April 27

willingness to sell up to $1,500 million if the demand appeared. Even though the issue was unexpectedly small, underwriters had difficulties finding investors interested in the 4¼s and had to take losses to clear out inventories. The new bonds dropped to 99 before April 14, when payments were due, and traded around 99 during the remainder of the month.

Congressional opponents of removal of the 4¼ per cent bond rate limit had challenged the Treasury to go ahead with a 4¼ per cent bond offering. Indeed, the bond market itself had challenged the Treasury to offer 4¼s; at the time the bond financing decision was made, on March 31, older issues of U.S. bonds due beyond ten years were being offered at yields to the investor ranging from 3¾ to 4⅛ per cent. The market reaction to the Treasury's offering showed that there was little substance of demand for U.S. bonds at these yield levels. Prices faded when the Treasury 4¼s, and a spurt of new corporate bond offerings, put the market to the test.

Secretary of the Treasury Robert B. Anderson drew the obvious conclusion that the disappointing results "indicate that suggestions to the effect the Treasury could get a substantial amount of debt extension, either by cash or advance refunding, under the 4¼ per cent (legal) rate ceiling were not well founded." Only a slightly higher rate might have produced the amount sought.

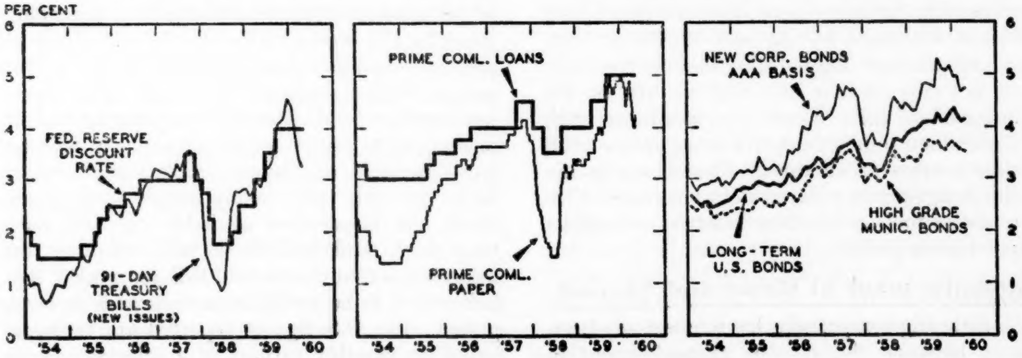
If the Treasury had attempted to raise $500 million by the auction method of sale, commended by the Congressional Joint Economic Committee majority, the result clearly would have been a cost beyond 4¼ per cent. The offering did fit another dictum of the JEC majority — set a "monopsonistic" rate and let investors take it or leave it. Unfortunately, many investors chose to leave it, preferring to place money in shorter term Treasury obligations or in corporate stocks or bonds.

Some buying interest was discouraged by the fact that the bonds were made callable — at par — after 15 years. Callability, favored by the JEC majority, is objectionable to the investor particularly since — unlike typical corporate bond call provisions — no premium is offered when Treasury issues are called prior to maturity. Callability at par is a "heads you win, tails I lose" proposition for the investor. The securities will be called for redemption and cease to bear interest if 4¼ per cent sometime after 15 years is an attractive rate — that is, if going market rates are lower and the Treasury can refinance more cheaply. On the other hand, the investor will be left hung up with the bonds if 4¼ per cent should turn out to be a poor rate of interest — that is, if market interest rates rise above this level.

The Constructive Achievement

Yet, some constructive purposes were served by the bond offering. Although it becomes the smallest of all Treasury bond issues, and represents less than one seventh of one per cent of the aggregate federal debt, $370 million is not an insignificant sum. Repeated offerings on the scale of $500 million over time could accomplish worthwhile debt extension and meanwhile keep the Treasury in effective touch with the market. Moreover, a practical test was the only way to evaluate for sure how large or small the market for Treasury 4¼s might be. Knowledge is now at hand that advance bond refunding can hardly work within the compass of the 4¼ per cent limit.

Some suggestions were heard that "Wall Street" had boycotted the offering and that the Treasury had deliberately planned the issue as an answer to its critics rather than as a genuine



Money Rates and Bond Yields, Monthly

effort to place bonds with investors. It was said that the Treasury had not given enough advance notice of the sale and had not left the subscription books open long enough for investors to get all they wanted. Such criticisms do not stand up under examination. So far as the boycott question is concerned, underwriters in Wall, La Salle, and Main Streets took more bonds than they could sell, lost money on the deal, and could only wish they had been less optimistic over retail demand. The fact that subscription books were open for only two days, and with only a few days' advance notice, no doubt left some potential buyers unready to enter subscriptions to the issue. But any such buyers had opportunity to get all they wanted in the secondary market, and, as matters turned out, at prices below par.

In light of the disappointing results on the 4¼ per cent bond offering, Congressman John W. Byrnes of Wisconsin was led to comment:

> Unless this Congress is to sit idly by while our huge Government debt grows shorter and shorter in maturity, with possible severe damage to our domestic economy and impairment of public confidence, the archaic 4¼-per cent interest rate ceiling must be removed once and for all without delay.

Meanwhile the Treasury is compelled to rely exclusively on the more volatile shorter-term market for the money it needs. This market has been subject to unusually violent movements during 1960. Borrowing costs on 91-day Treasury bill issues dropped from about 4½ per cent in early January to as low as 2¾ per cent in early April and have subsequently fluctuated between 3 and 3⅝ per cent. The one-year Treasury bills dated April 15 were auctioned at an average yield of 4.61 per cent, equivalent to a cost of 4.84 per cent if computed on a bond basis.

Short-term borrowings are not necessarily a bargain in money cost to the Treasury. It is true that bills do not run for long periods and borrowing costs on bills quickly retreat when rates decline. On the other hand, the volatility of bill yields is increased by the vast $37 billion outstanding amount. Bigger bill issues raise interest costs not only on new bills sold but also on the rollover of old bills. There is no substitute, with a $289 billion public debt, to having access to all maturity areas at all times. Confidence in the dollar hangs on an ordered debt structure. This is a matter that, as in other countries, should be beyond party politics.

Unemployment at Home and Abroad

Unflattering comparisons have repeatedly been drawn between the rate of unemployment in the United States and lower levels reported in various foreign countries. One of the latest appeared in the Report of the Special Senate Committee on Unemployment Problems, released on March 30, which included, as one of nine major conclusions, the statement that:

> High rates of unemployment are not a necessary part of the private enterprise system. Unemployment can be reduced by reasonable private and public policies, as demonstrated by the experience of Great Britain, Sweden, Norway, Finland, the Netherlands, Switzerland, and France. The unemployment rates in these countries are considerably lower than those in the United States.

There is no quarrel with the opening sentence of this statement, but we need to take a closer look at the evidence that rates of unemployment are considerably lower in Western Europe and ponder the "private and public policies" sometimes used abroad to harness people to their jobs. The following table shows rates of unemployment in 1958 and 1959 in the countries cited by the Committee, except France and Finland which do not regularly publish rates:

	Unemployment as per cent of the labor force	
	1958	1959
United States	6.8	5.5
Great Britain	2.2	2.3
Sweden	2.5	2.0
Norway	2.3	2.2
Netherlands	2.4	1.9
Switzerland	0.5	0.4

Source: United Nations, *Monthly Bulletin of Statistics.*

The contrast in unemployment rates between the United States and these other nations may appear striking at first glance, but the differences are more superficial than real. The trouble is that these comparisons ignore the very large differences in concept and measurement of unemployment, degrees of industrialization, local practices and customs, and the amounts of government intervention in business which different peoples tolerate.

One reason U.S. unemployment figures look relatively high is that the United States has one of the most all-inclusive definitions of unemployment in the world. The aim is to include all persons unemployed and looking for work, with certain other groups added on for good measure: workers with jobs but temporarily laid off or waiting to report; persons unable to look for work because of illness; workers who voluntarily quit their jobs; many people such as students and housewives available only for part-time work; and individuals who volunteer the information that they would look for work if they believed it to be available in their area or occupation. The U.S. figures reported are estimates based on monthly surveys of a selected sample of households.

In the other countries listed, unemployment figures are based on true counts of persons who register themselves as looking for work. Such registration is voluntary, but necessary if the person wishes to collect unemployment insurance. The number out of work tends to be understated to the extent that certain groups are not covered by the unemployment insurance program or choose not to register.

Some Closer Comparisons

In Great Britain, whole classes of jobless persons are unlikely to be covered by registration data although they would be counted as unemployed by American standards. These include: married women and persons on pensions who generally have chosen not to contribute to the insurance program; casual workers and certain other groups not covered by the program; persons who quit voluntarily or are otherwise disqualified from receiving benefits; and persons who desire to shop around for a job on their own instead of being referred by the employment exchange to one which they might not like. Professor H. A. Turner of Manchester University, analyzing the British figures in the May 1959 issue of the *Manchester School of Economic and Social Studies,* concluded that:

> . . . the total of such concealed unemployment would have represented between 2½ and 3 per cent of the employees; and had the official unemployment percentage, 2.4, on the 8th of December 1958, been compiled by methods like that used in the United States, which picked up such people, it would probably have been more than double.

Sweden presents an even better example of how the U.S. procedure may produce bigger unemployment figures. The August 1959 issue of *Labor Developments Abroad,* compiled by the United States Department of Labor, contained the following report from Sweden:

> Old-style unemployment statistics, based on registrations at public employment agencies, showed a total of 47,000 unemployed persons in April 1959. A new survey for the same period, based on U.S. sampling methods, showed a total of 136,000. Unregistered youth (waiting for training opportunities) and housewives (who are seeking work but have not registered) accounted for the difference.

Thus, use of American concepts and measurement would come close to tripling Swedish unemployment estimates.

Basic Differences

It seems probable that the difference between unemployment rates in the United States and in each of the countries cited by the Senate Committee Report would be sharply narrowed if the data were collected on a comparable basis. Much of the remaining discrepancy can be accounted for by the greater mobility of labor in the United States. People move from job to job and place to place more freely in this country. Generosity of unemployment insurance benefits, permitting or even inviting people to take their time finding another position, can add to jobless totals. In economies where agriculture is more important than in the United States, unemployment often takes the form of under-employment in farming.

Another factor is the amount of government intervention in the economy which the people of different countries will tolerate for the sake of reducing unemployment. The Senate Committee submitted a long list of recommendations for government action to reduce unemployment and boost employment, but they stop well short of the degree of control already exercised by many foreign governments. For example, none of the recommendations goes so far as the laws which in numerous countries today make it well-nigh impossible for an employer to lay off or discharge a worker. Such regulations hold down unemployment only at the expense of simultaneously holding down efficiency and productivity.

The countries which combine a maximum of regulation with — purportedly — a minimum of unemployment are those behind the Iron Curtain. According to Marxist doctrine, there is no unemployment in the idealized Socialist state. Theoretically, there is a job for everyone, whether he wants it or not. Actually, despite rigid control of business and regimentation of individuals, serious unemployment problems have arisen east of the Iron Curtain. The most recent example is in Poland, as reported in *The New York Times* early in April. On March 15, Polish Government reports showed that 56,700 women were registered for jobs, but only 4,200 vacancies were available for them. The Polish Government, according to the *Times,* had aimed to create a pool of unemployed, which would induce greater worker competition and thus raise productivity. As happens to so many economic plans, the situation got out of hand.

In this country, private efforts have joined with public programs in attempting to smooth out seasonal and cyclical swings in business and to alleviate the hardship of unemployment. Yet there is no desire to handcuff the employer to the worker. American labor cherishes its "right *not* to work" — the right to quit or to refuse a job one doesn't like, to strike, to rest or look around between jobs, or to retire voluntarily. Absolute full employment can be achieved only at the expense of personal liberty. The best cure for un-

employment in the United States is to encourage people to move from areas and occupations where surpluses of labor exist to areas and occupations where employers have difficulty filling vacancies.

Troubles of Small Business

Ever since the first Russian Sputnik began circling the earth more than two years ago, a good many voices have been raised urging greater efforts in this country to match and surpass Soviet accomplishments in such fields as space exploration, education, scientific research, and economic growth. These admonitions have usually been accompanied by much well-intentioned advice as to just how to go about the job. Often such prescriptions would entail adoption of Russian-type bureaucratic controls, features obnoxious to Americans.

It should give pause to advocates of state planning that Soviet successes in the economic field may be largely attributable to new emphasis there on incentive systems. They have rediscovered the simple truth — long familiar in the West but sometimes neglected — that appropriate rewards are needed to stimulate and encourage individual effort and initiative. The Russian example in this matter may serve as a useful reminder that a primary resource for our unparalleled industrial growth has been the restless energy of individual enterprisers.

Such a reminder is especially needed today as Congress considers the perennial problems of the small businessman. The unique and vital role played in our daily lives by more than four million small enterprises is familiar to all. Apart from their normal functions of supplying myriads of goods and services needed in our economy, these smaller firms also provide an indispensable breeding ground for new products, better services, and technical innovations. Most of our great industries trace their origins to the activities of small, pioneering firms.

Congress in the past has shown a good deal of sympathy for the small businessman. But the solutions for his problems that have found favor on Capitol Hill usually have been aimed at secondary symptoms rather than the real ailments. Most commonly, efforts have been directed at providing taxpayer moneys to lend to small firms. At times the theory has almost seemed to be that the only salvation for the small businessman is in getting him head over heels in debt.

In authorizing small business investment companies in 1958 the Congress recognized that one of the chief stumbling blocks faced by small businessmen is their inability to accumulate sufficient capital to expand. But the legislators have been less frank in facing the fact that the greatest obstacle to all profit-seeking enterprise is the heavy and bewildering burden of taxation. Taxes, among other regulations, create a good part of the small business problem that Congress is forever trying to solve. Just how complex the tax laws have become is indicated by the 1960 edition of the Government's *Tax Guide for Small Business* which runs to 143 pages. And this book does not try to answer all the questions and explain all the intricate details.

"An Incomprehensible Hodgepodge"

The difficulties created by taxes were forcefully brought home by one small businessman in a letter inserted into the *Congressional Record* last month by Rep. Edith N. Rogers of Massachusetts. The writer, V. H. Pomper, an officer of a small firm in Maynard, Mass., vented his criticisms of the tax laws in the following vein:

> As a businessman in a small company with under 300 employees, we almost daily are faced with inequities and contradictions in present tax laws and rulings. They represent an incomprehensible hodgepodge and crazy quilt, which I believe and find to have effects opposite to those for which they were supposedly intended.
>
> The tax laws place a particular burden on small businesses, with their greater requirements for capital with which to grow. So many small businesses who are successfully providing jobs and opportunities for personal advancement are forced to merge or sell out to large companies because the tax laws bleed them dry of capital needed in the business. Too often the tax situation dries up rather than creates jobs and job security. . . .
>
> We are engaged in a competition with the Soviet Union, which seems to be successfully fostering a more rapid rate of growth than is the case here. Is it perhaps part of the reason that the Russians reward conspicuous excellence conspicuously? . . . We need to rekindle the spirit of risk, of enterprise, of venture, of standards of excellence, rather than the soft and soggy standards of "Oh, what's the use" or of sleazy "corner-cutting." But by any standard, whether moral, spiritual, political or economic, I do not believe the tax laws at present are just or effective.

As other forward-looking nations have done, we need to get on with the job of overhauling our tax system to provide greater encouragement for the free play of individual ingenuity and effort. Although the same principle applies in many other fields, small business is an instructive example of an area in which less — rather than more—government interference could enlarge the national income by expanding the range of opportunities open to persons gifted with drive and imagination.

Interest Rates and the U.S. Gold Reserve

In 1960, as in every election year, it is natural for the major political parties to seek out issues that will have popular appeal and win votes. One such issue — prominent in Congressional debates since last June — concerns money rates and the cost of interest to the U.S. Treasury. We hear suggestions that the Federal Reserve should support the bond market to reduce interest levels and make it easier for everyone to borrow. Cheap money advocates rarely acknowledge that what they recommend is inflation of the money supply and prices. Moreover, they tend to overlook the revival of the international money market: if interest rates are arbitrarily held down in this country, money may simply flow to other centers where rates of return are more attractive and where there is a greater sense of security in the future value of money.

Sharp fluctuations in money rates both here and abroad in recent months underscore the importance of the revived competition among the leading money market centers. The potential for international movements of short-term funds has greatly increased since the end of 1958 as Western European currencies have again become convertible, at least for nonresidents, and exchange controls have been greatly eased. Commercial banks and business firms can now hold and use their dollars as they wish, instead of being compelled to turn them over to their governments. The rebuilding of official gold and foreign exchange reserves, in many cases to record levels, has instilled a fresh new confidence in key currencies abroad. Exchange and money markets in the major foreign financial centers have been regenerated and are growing in scope and flexibility.

In the 1958 business recession, at a time of a greatly enlarged U.S. balance-of-payments deficit, we saw how cheap money and a huge budgetary deficit could drain gold out of the country. The U.S. gold stock in that year fell by $2,247 million, the largest loss in any calendar year since World War II. As credit was restricted and the federal budget brought closer to balance, the drain on the gold reserve began to ebb. In 1959, even though the payments deficit was actually somewhat larger than in the previous year, the gold outflow was reduced to $1,078 million. It is true that most of the Western European countries that traditionally hold the bulk of their reserves in gold gained substantially smaller amounts of dollars in 1959 than in 1958; but the increase in money rates in our market and a tightened federal spending policy put brakes on the gold outflow.

As 1960 is shaping up, the balance-of-payments deficit may be less than in each of the past two years. The gold outflow has actually been moderate — only $96 million through April 27. But to keep the drain on our gold within limits, foreign nations acquiring dollars must not only trust the dollar but must also find it attractive to hold dollar assets.

Foreign-Held Dollar Assets

In February 1960, foreign countries as a whole held $16.1 billion of short-term dollar assets. Of this amount, $8.9 billion was in official accounts maintained by treasuries and central banks, and $7.2 billion in private accounts. This $16.1 billion represents a $10.2 billion gain since 1949 when, through devaluations, principal international currencies were brought into relationships which could remedy the seemingly intractable problem of dollar shortage, lay a foundation for restoration of convertibility, and foster world trade expansion.

Foreign Short-Term Dollar Assets as Reported by Banks in the U.S., by Categories of Holders*

(In Millions of Dollars)

		Private			
	Official	Banks	Others	Total	Total
Dec. 31, 1949	$2,908	n.a.	n.a.	$3,001	$ 5,909
Dec. 31, 1954	6,783	2,533	1,799	4,332	11,115
Feb. 29, 1960	8,865	4,950	2,283	7,233	16,098

* Excluding international financial institutions. n.a. — Not available. Source: Adapted from *Treasury Bulletin.*

As the table shows, the first five years' increase mainly replenished the shrunken official holdings. Since December 1954, and particularly since the end of 1958 when European currencies became externally convertible, the rise in commercial bank holdings has become more prominent. These holdings reflect the growing business foreign banks are doing in dollar deposits.

Foreign short-term dollar assets, by long-accepted usage, include not only demand deposits (carried with the Federal Reserve Banks and commercial banks) but also, and in much larger amounts, short-term interest-bearing assets:

Foreign Short-Term Dollar Assets as Reported by Banks in the U.S., by Categories of Assets, February 29, 1960*

(In Millions of Dollars)

	Official Institutions and Commercial Banks	Nonbank Businesses and Individuals	Total
Deposits, demand and time	$ 5,957	$1,750	$ 7,707
Treasury bills and certificates	6,252	228	6,480
Bankers' acceptances, commercial paper, etc.	1,606	305	1,911
Total	$13,815	$2,283	$16,098

* Excluding international financial institutions. Source: *Treasury Bulletin.*

Treasury bills and certificates, bankers' acceptances, commercial paper, and time deposits with U.S. commercial banks.

One complication inherent in these statistics, compiled for the U.S. Treasury, is that "Banks in the United States" are defined to include agencies of foreign banks operating in this country. American banks, denied opportunity to pay competitive rates of interest for deposits,* probably do not account for more than two thirds of the $7.7 billion foreign demand and time deposits.

Besides these short-term assets, interpreted as "money," foreigners of course have large long-term investments in bonds, stocks, and direct property ownership. They are known to have held at the end of 1959 $1.5 billion U.S. Government bonds and notes — $0.5 billion more than the previous year. Most of this increase came during the second half of 1959 when yields on Treasury notes and some bond issues reached 5 per cent.

Every country in the world has some short-term dollar assets. The nine biggest holders, shown in the table below, accounted for 64 per cent of the $16.1 billion total last February.

Principal Foreign Holders of Short-Term Dollar Assets, February 29, 1960

(In Millions of Dollars)

Canada	$2,260	Switzerland	$ 939
Germany	1,908	France	675
Japan	1,291	Netherlands	493
Italy	1,245	Mexico	420
United Kingdom	1,109	All others	5,758

Source: *Treasury Bulletin.*

The International Monetary Fund, the World Bank, and other international financial institutions also hold dollar assets. At the end of last year, these totaled $3.8 billion, of which short-term assets accounted for $3.2 billion and U.S. Government bonds and notes for the remainder. Two thirds of these short-term assets consisted of non-negotiable non-interest-bearing demand notes issued by the U.S. Treasury to the International Monetary Fund.

Sensitivities to Interest Rates

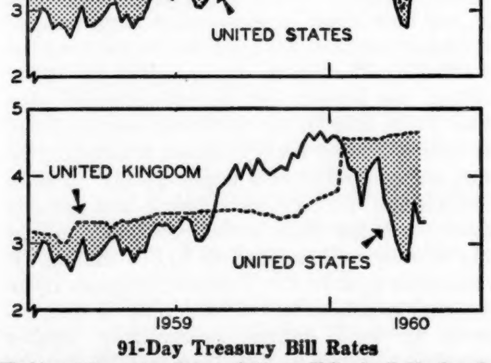
So long as the United States pursues sound monetary and fiscal policies, the dollar can keep its status as the world's leading reserve currency. Dollars invested at short term, or deposited in U.S. banks, will be regarded as equivalent to gold.

Assets held by international institutions have not been responsive to differentials between interest rates here and abroad. The same has been true of working balances of dollars to finance transactions. The need for such balances has increased as the foreign trade of the United States has expanded and as settlements in dollars have become increasingly common among foreign countries. Sizable amounts of dollars need to be accumulated to service dollar debts. Some foreign dollar assets are held here for safekeeping or convenience, while still others are held to cover liabilities to American residents; funds of these sorts are generally unresponsive to fluctuations in interest rates.

Dollars accumulated beyond these basic needs become sensitive to money rates. Extremes of cheap money here, especially at a time of weakening confidence in the dollar, tend to induce conversions of foreign official balances into gold; the loss of income then becomes a secondary consideration. Private dollar balances are most apt to respond to money rate differentials between our market and the principal markets abroad. And it is not just foreign money that becomes tempted to move abroad; if the spreads are big enough, Americans with surplus funds may be led to put money in foreign money markets.

Two Recent Examples

We have had some practical examples over the past year. In August 1959, the rate on 91-day Canadian Treasury bills jumped to 6 per cent — nearly double the then prevailing rate on 91-day U.S. Treasury bills. American banks prominent



91-Day Treasury Bill Rates

Weekly auction rates. Latest plottings: U.S., April 25; Canada, April 21; U.K., April 22. The shaded areas show excess of foreign yields over U.S. yields.

*For a discussion of impediments to American bank competition in this area, see the article on Regulation Q in the April 1960 issue of this *Letter.*

in international banking received numerous inquiries from customers regarding the advisability of shifting money into the Canadian market.

The profitability of moving U.S. dollar funds into Canadian Treasury bills depended, of course, not only on the differentials between bill yields but also on fluctuations in the U.S.-Canadian exchange rate. The Canadian dollar has no fixed value in terms of the U.S. dollar and fluctuates from day to day in accordance with supply and demand, with the Canadian Exchange Fund intervening only to contribute to orderly market conditions.

The first thing that an uninitiated potential investor in Canadian Treasury bills discovered last August was that he would have had to pay a rather fancy price for the Canadian dollar – about U.S. $1.05 – and that a fall of 1½ cents in the exchange rate over the three-month period would have wiped out his entire 6 per cent income. This exchange risk could, of course, have been covered by forward buying of U.S. dollars at a cost which, at the time, was equivalent to 2 per cent per annum. Allowing for the cost of cover, Canadian bills in mid-August thus yielded some 4 per cent. However, as the spread in bill yields attracted money from New York and thus strengthened the Canadian dollar, the profitability of covered arbitrage diminished rapidly. Recently, Canadian bill yields have declined closer to the U.S. level and the premium on the Canadian dollar has also receded.

In the last month or two, investment interest has turned to moving short-term funds to the United Kingdom, where the authorities keep the pound within limits of $2.78-2.82. Early in April, British bills yielded almost 2 per cent more than U.S. bills. Including the cost of covering, the differential early last month was about 1 per cent. Some money is known to have moved from New York to London without cover. Subsequently, as the sterling-dollar rate firmed and the gap between the British and U.S. yields was reduced, interest arbitrage became less worthwhile.

Underlying the rise in interest rates in the United Kingdom, as well as on the Continent, is the ebullience of European business together with renewed monetary restraints to check excessive demand. Since last fall, central bank discount rates have been raised in most European countries, including the United Kingdom, Germany, the Netherlands, Sweden, Denmark, and Austria. The discount rate has also been increased in Japan.

Long-term Government bonds in the United Kingdom and Canada currently yield more than 5 per cent; bond rates in Germany are even higher. The much lower levels of bond yields in the United States add to our balance-of-payments deficit by inviting foreign borrowers and international institutions to come to this market for funds.

Exposure and Challenge

The United States today is more exposed to drains of funds than has been true for many years. European currencies have become more comparable in strength to the dollar; the international money market has become more competitive.

This does not mean that we cannot take reasonable measures, including easier credit conditions, to deal with business recessions. Nations abroad would expect us to undertake such measures, as they would do in similar circumstances. They have a large stake themselves in the maintenance of trade activity in the country which provides the biggest import market in the world.

But it is clear that we will need to exercise more discretion than at some times in the past in the use of economic stimulants. Specifically, we can no longer afford to carry cheap money to extremes or let go the reins on government spending. As pointed out a month ago by Professor Arthur F. Burns of Columbia, the nation's most distinguished expert in business fluctuations, we need to find fiscal policies, such as tax reforms, which can check recessions and stimulate creative effort and growth without opening the floodgates to inflation.

In a world in which market mechanisms – prices, exchange rates, and interest rates – are working once more, the long insulation of the United States from the discipline of the balance of payments has come to an end. Today, the United States, however richly-endowed and productive, can no longer conduct its domestic financial affairs without regard to its ability to supply goods and services at competitive prices, to maintain interest rates in line with those in the principal markets abroad, and to preserve a feeling of complete confidence in its currency by its own people as well as by foreigners.

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